TAM ASSET MANAGEMENT, INC.

ASSET CLASS[sm]

An update of performance, trends, research, & topics for long-term investors

June 2004

Asset Class Returns

	2001	2002	2003	Last 10 yrs.	5/30 2004
Bonds					
Short-term	5.8	3.9	1.6	5.0	0.1
Five-Year	5.9	10.4	3.0	6.8	-0.7
Intermediate	8.2	15.0	2.5	6.9	-1.0
Long-term	4.3	16.7	2.7	7.7	-1.1
U.S. stocks					
Large Market	-12.1	-22.2	28.5	10.9	1.4
Large Value	3.9	-14.9	34.4	12.1	2.7
Small Micro	22.8	-13.3	60.7	14.8	2.6
Small Market	12.7	-19.1	51.5	12.2	4.4
Small Value	22.6	-9.3	59.4	15.6	2.1
Real estate	13.2	4.2	35.6	10.8	2.9
Int'l stocks					
Large Market	-20.8	-14.6	36.7	4.9	1.9
Large Value	-15.3	-8.5	49.4	7.0	5.0
Small Market	-10.5	1.9	58.8	4.8	8.5
Small Value	-4.6	5.8	66.5	6.1	8.9
Emerg. Mkts.	-6.8	-9.4	60.2	2.3	-1.0

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
Five-Year bonds	DFA Five-Year Global Fixed
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Long-term U.S.Treas.
U.S. Large Market	DFA US Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA US Micro Cap fund
U.S. Small Market	DFA US Small Cap fund
U.S. Small Value	DFA US Small Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Large Cap Int'l fund
Int'l Large Value	DFA Int'l Value fund
Int'l Small Market	DFA Int'l Small Company fund
Int'l Small Value	DFA Int'l Small Cap Value fund
Emerging Markets	DFA Emerging Markets fund

"Last 10 yrs." returns are ended 12/31/02 and for U.S. Large Value (3/93), U.S. Small Value (3/93), Int'l Large Value (3/93), Int'l Small Market (10/96), Int'l Small Value (1/95), and Emerging Markets (5/94) include simulated data prior to fund inception (in parentheses).

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16,954 (and counting...)

Jeff Troutner, TAM Asset Management, Inc.

That number represents the madness that is the mutual fund industry. It is the total number of mutual funds now included in the Morningstar Principia database and is the clearest indication that mutual funds are simply "products" to be sold to investors. How they are packaged, marketed, and sold appears to be much more important than what value they may offer. In fact, today's mutual fund business reminds me of the shampoo business. How many different combinations of the basic ingredients (stock picking and market timing), bottle designs (class shares), weight and pricing schemes (advisory fees, loads, and 12(b)-1 fees), and distribution outlets (banks, stockbrokers, and fund "supermarkets") do you need to solve the simple task of washing your hair (realizing asset class returns)??

What's missing in the shampoo business is an "unbiased" third-party to help you sort through the thousands of available choices (sorry, Renaldo, Alexandra, or whoever cuts your hair is not an impartial source). Important criteria could be used to decide the best shampoo value (desired results versus price paid). Shampoo companies would then aggressively compete for the coveted "5-Bottle" rating and sales would soar for the winners. It would be a win-win situation, I'm sure. Now, if only we had a similar service in mutual fund business…

Ah, but there is. It's the Morningstar Principia database and for a mere $615 per year you can receive monthly updates on those 17,000 funds, complete with "Star" ratings and "Style Boxes." Unfortunately, neither is very useful in selecting funds that will provide superior future performance at a reasonable cost to investors. In fact, I think it would be a lot more fun and just as useful if they used the "Lucky Charms" system of pink hearts, yellow moons, orange stars and green clovers. After all, luck seems to be the biggest component of their current system.

Morningstar uses a scheme that ranks funds from 1 (lowest) to 5 (highest) stars. Their methodology changed in 2002, no doubt based on a number of very unflattering studies published in the late nineties, and the verdict is still out as to whether they improved things at all. For sake of argument we'll assume they haven't found the magic formula. So let's look at what we do know.

One academic study by Christopher Blake and Matthew Morey (Fordham University) showed that for the five year period ended 12/31/97 the Morningstar 5-Star rated funds underperformed a total market index by almost 4% per year![1] A follow-up study by Morey published in September 2003 concludes that after receiving a 5-Star rating for the first time, "fund performance severely falls off."[2]

In 2001, John Bogle, the former chairman of The Vanguard Group, looked at a study by Mark Hulbert of the Hulbert Financial Digest and wrote:

continued on back...

"During the period 1993-2000, the total return on Morningstar's top-rated U.S. funds averaged +106%, vs. +222% for the total stock market (the Wilshire 5000 Equity Index). What is more, these funds carried a relative risk (measured by standard deviation vs. the total market) of 1.26. Achieving but 48% of the market's generous reward while assuming 26% more risk is hardly a tribute to the staying power of the stars.[3]

Okay, so the Morningstar system does a poor job of predicting future performance. Then what good is it? Well, let's say some investors are enlightened enough to do their own screens and eliminate all actively-managed funds (this makes sense since the only reason to own an actively-managed fund is the hope of "beating the market" and the premier mutual fund rating service can't help you do that). This takes the 17,000 fund universe down to about 700. Eliminating the various "shares classes" (all the different ways to extracts fees from investors) takes the list down to about 400. Screening out those with expense ratios above 1.0% and knocking off another 50 or so "sector" (e.g., technology, utilities, software, etc.) funds and you are left with about 250 funds to seriously consider. Now that's useful!

There's just one little problem. Out of those 250 remaining funds, only one is managed by Dimensional Fund Advisors (who we believe is the best "index" fund manager around). For retail investors who do not have an advisor relationship, this isn't really an issue since they do not have access to the DFA funds. But what if (a) you want to compare your retail index funds to a DFA-variety "asset class" fund or (b) you have an advisor and you want to make sure he or she is investing in the best funds for your portfolio. In order to do this, you have to include the DFA family of funds in your screen.

Alas, there's another little problem. Morningstar's system is a bit schizo and assigns a different number of stars and style categories to identical DFA funds. Table 1 shows this problem for three different asset classes.

Interesting. The funds in each asset class category invest in precisely the same securities via a "master" fund vehicle. The different varieties of these funds indicate a slightly different expense structure (DFA allows some of their larger advisors to "private label" some of the funds).

Table 1: Same DFA Funds, Different Stars & Style

Fund Name	Stars	Style
AAM/DFA US High BtM	★★★★	Large Value
US Large Cap Value	★★★	Mid-Cap Value
US Large Cap Value III	★★	Mid-Cap Value
US Large Company	★★★★	Large Blend
US Large Co Institutional	★★★	Large Blend
International Value III	★★★	Foreign Lrg. Value
International Value	★★★	Foreign Lrg. Value
AAM/DFA Intl High BtM	★★	Foreign Sm/Mid Value

Sometimes Morningstar assigns a lower star rating to an identical fund with a higher 5-year return and lower expenses. US Large Cap Value III, for example, has slightly lower expenses than US Large Cap Value and hence slightly higher net returns for the five year period ending December 31, 2003. Yet Morningstar ranks it two stars *lower*. Go figure.

Table 2: Higher Returns, Fewer Stars

Fund Name	Stars	Return 5-Yrs.	Expense Ratio
AAM/DFA US High BtM	★★★★	6.41%	0.36%
US Large Cap Value	★★★	6.53%	0.32%
US Large Cap Value III	★★	6.66%	0.19%
US Large Company	★★★★	-0.75%	0.15%
US Large Co Institutional	★★★	N/A	0.10%
International Value III	★★★	6.38%	0.35%
International Value	★★★	6.10%	0.53%
AAM/DFA Intl High BtM	★★	6.17%	0.54%

To be fair, we shouldn't just pick on Morningstar. Several of the most popular financial publications have their own rating systems that produce some interesting inconsistencies. Table 3 shows some samples.

Table 3: What is an Investor To Do?

Fund Name	Morning-star[4]	Business Week[5]	Wall St. Journal[6]
Europacific Growth	★★★★★	C	D—B—E
Fidelity Contrafund	★★★★★	C	E—A—A
Fidelity Growth & Income	★★★★	C-	E—B—B
Neuberger Berm. Genesis	★★★★	A	E—B—A
Vanguard Index 500 Inv	★★★★	C-	A—A—A
Washington Mutual Inv.	★★★★	C	D—A—B
Cohen & Steers Realty	★★★	A	B—C—B
Goldman Sachs SC Value	★★★	A	C—A—A
Janus SC Value Inv	★★★	A	D—D—B
Van Eck Intl Investors	★★★	A	E—C—E

So the next time you have a question about how a particular fund in your portfolio is "ranked" (or what shampoo you should buy), please call us first. We'll clean the data and give you a truly meaningful perspective.

[1] *Christopher Blake and Matthew Morey, "Morningstar Ratings and Mutual Fund Performance," Journal of Financial and Quantitative Analysis, September 2000*

[2] *Matthew Morey, The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating?, September 2000*

[3] *The Stock Market Universe—Stars, Comets, and the Sun. Remarks by John C. Bogle before the Financial Analysts of Philadelphia, February 15, 2001*

[4] *Star rating as reported in Morningstar Principia, January 2004.*

[5] *Overall rating as reported in "Equity Fund Scoreboard," BusinessWeek (January 26, 2004): 91-103.*

[6] *Ranking as reported in Quarterly Review of Mutual Funds, Wall Street Journal (January 8, 2004): R1-R26.*